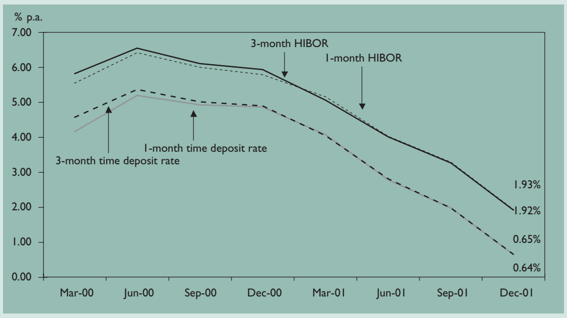
The fourth quarter saw a continuation of the trends evident in the first nine months of the year, with the global economic slowdown, exacerbated by the events of 11 September, impacting on loan demand, and competition for business driving down margins. Asset quality, overall, continued to improve, although losses on credit card lending increased sharply due to the rising number of personal bankruptcies. Profitability appears to have held up reasonably well, with preliminary figures suggesting that the operating profits of the retail banks as a group (see box insert within this article) in respect of their Hong Kong offices fell only slightly in 2001.

Interest Rate Movements

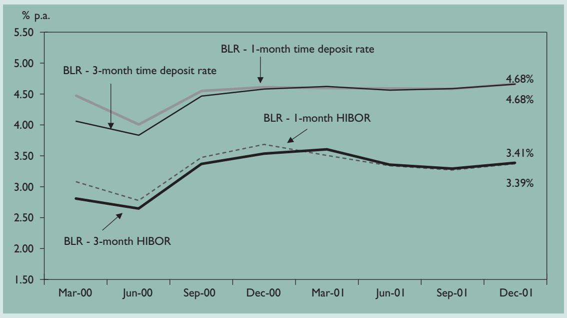
The US Federal Reserve lowered its Federal Funds rate three times by a total of 125 basis points in the fourth quarter. In response, major commercial banks lowered their best lending rate[1] (BLR), but by a smaller amount of 87 basis points to 5.13% from 6.00%. Other domestic interest rates also fell. Average one and three month HIBORs dropped by 136 basis points while average one and three month time deposit rates dropped by about 134 basis points (Chart 1).

Chart 1
HIBORs and Time Deposit Rates
Quarterly Average



As average HIBORs declined by more than BLR, spreads between the two widened, with the spreads between BLR and average one and three month HIBORs widening by 10 basis points, to 3.39% and 3.41% respectively. Similarly, the spread between BLR and average one and three month time deposit rates increased, by 8 basis points to 4.68% and by 7 basis points to 4.68%, respectively (Chart 2).

Chart 2
Best Lending Rate (BLR) - HIBOR/Time Deposit Rate Differentials
Quarterly Average



Profitability

Preliminary figures indicate a slight decline in the retail banks' aggregate operating profits (in respect of their Hong Kong offices) in 2001. This was due mainly to a combination of a reduction in net interest income and increase in total operating expenses, which outweighed an increase in other operating income and decline in provisions for bad

1 Best lending rate refers to the rate quoted by the Hongkong and Shanghai Banking Corporation Limited.

Box
Introduction of the "Retail Banks" Grouping

With effect from this issue, a new bank grouping, termed "retail banks", is introduced. This comprises all the locally incorporated banks plus a number of the larger foreign banks which are not locally incorporated but whose operations are similar to those of the locally incorporated banks, in that they operate a branch network and are active in retail banking. The thinking behind creating this new grouping is that it will be more representative of "mainstream banking" trends in Hong Kong than the "all authorized institutions" grouping (which includes many institutions whose activities are primarily of an offshore or wholesale nature), while at the same time capturing a greater percentage of domestic lending and deposits (around three-quarters of the total) than the "locally incorporated banks" grouping (around one half of the total).

As indicated by Charts A-C, the trends in the asset quality, net interest margin and bad debt charge of the "retail banks" grouping are broadly similar to those of the "locally incorporated banks" grouping, which was previously employed for monitoring trends in these performance indicators.

Chart A
Asset Quality

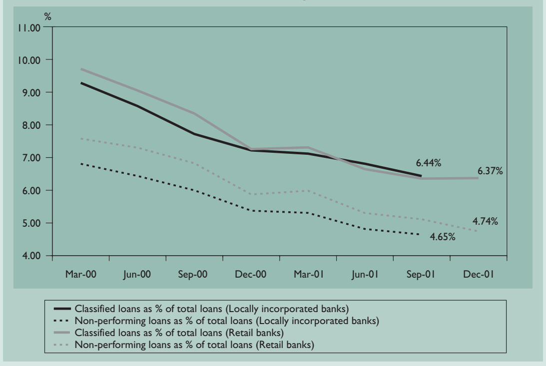


Chart B
Net Interest Margin (Annualised)

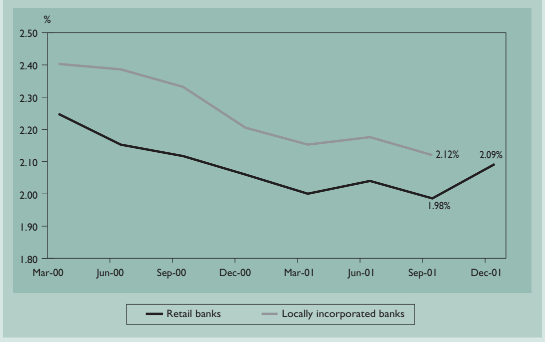
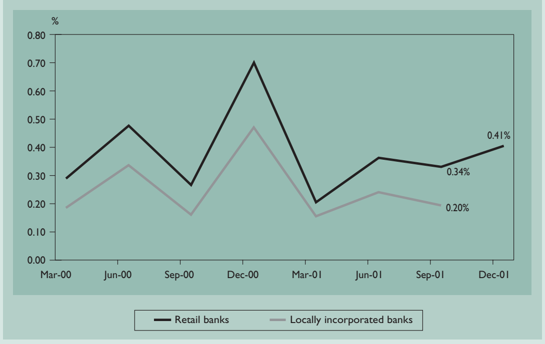


Chart C
Bad debt charge as % of average total assets



and doubtful debts. As usual, the aggregate figures conceal wide variations in the movement of individual banks' figures.

Despite the widening of spreads between BLR and average HIBOR/time deposit rates, the continued squeeze in lending margins arising from intense competition among banks, particularly in residential mortgage lending, plus the impact of falling interest rates on free funds (i.e. the endowment effect), resulted in a contraction in the retail banks' net interest margin to 2.03% in 2001 from 2.14% in 2000 (see Chart B in box insert). There were, however, fluctuations from quarter to quarter, with the fourth quarter, for example, seeing an increase in the net interest margin.

Reflecting a greater increase in total operating expenses than in operating income, the retail banks' cost-income ratio rose to 42.3% in 2001 from 38.1% in 2000.

The retail banks' ratio of bad debt charge to average total assets declined to 0.33% in 2001 from 0.44% in 2000 (see Chart C in box insert), in line with the improvement in overall asset quality.

Capital Adequacy Ratio

Preliminary figures indicate that the average consolidated capital adequacy ratio of the "all locally incorporated AIs" grouping declined to 16.8% at end-December from 18.3% at end-September (Table 1). This reflects in part the effects of changes in the reporting population. The capital position, however, remains strong and well above international minimum standards.

Asset Quality

Notwithstanding the economic slowdown, with low nominal interest rates and (in many cases) lower spreads making debt servicing more affordable, the retail banks' asset quality continued to improve (Table 2 and Chart A in box insert). The non-performing loans ratio improved to 4.74% from 5.11% at end-September, while the ratio of three month overdue and rescheduled loans saw a similar improvement to 4.57% from 4.96%. The ratio of classified loans (gross), however, remained more or less unchanged at about 6.37%. Anecdotal information from the banks confirms that the quality of the corporate portfolio continues to hold up reasonably well.

The quality of banks' residential mortgage loan portfolios continued to improve. According to the monthly residential mortgage survey, the delinquency ratio of residential mortgage loans (measured by amounts overdue for more than three months as a percentage of the total mortgage portfolio) improved to 1.22% at end-

Table 1
Consolidated Capital Adequacy Ratio (All locally incorporated AIs)

(HK$ mn)

	Dec-00	Mar-01	Jun-01[2]	Sep-01[2]	Dec-01[3]
Total capital base after deductions[1]	259,314	265,518	267,292	278,215	308,586
of which core capital	*215,085*	*219,712*	*222,333*	*228,263*	*256,141*
Total risk-weighted exposures	1,455,703	1,453,517	1,488,726	1,518,837	1,838,896
Capital adequacy ratio	17.8%	18.3%	18.0%	18.3%	16.8%

Notes:

1. *Total capital base after deductions refers to total core and supplementary capital after deductions as specified under the Third Schedule to the Banking Ordinance.*
2. *Revised figures.*
3. *Preliminary figures.*

Table 2

Asset Quality[1]

	Dec/00	Mar/01	Jun/01	Sep/01	Dec/01
	as % of total loans				
Pass loans	**86.09**	**86.17**	**87.61**	**88.05**	**88.12**
Special mention loans	**6.65**	**6.52**	**5.74**	**5.60**	**5.51**
Classified loans (gross)[2]	**7.26**	**7.31**	**6.65**	**6.36**	**6.37**
of which Substandard	*2.31*	*2.29*	*2.32*	*2.05*	*2.14*
Doubtful	*4.05*	*3.96*	*3.54*	*3.34*	*3.17*
Loss	*0.89*	*1.06*	*0.79*	*0.97*	*1.06*
Classified loans (net)[3]	**4.93**	**4.94**	**4.66**	**4.37**	**4.53**
Overdue > 3 months and rescheduled loans	**6.04**	**6.11**	**5.31**	**4.96**	**4.57**
of which Overdue > 3 months	*4.87*	*5.09*	*4.39*	*4.22*	*3.96*
Rescheduled loans	*1.17*	*1.03*	*0.93*	*0.75*	*0.61*
Non-performing loans[4]	**5.87**	**5.99**	**5.30**	**5.11**	**4.74**

Notes:

1. *Period-end figures relate to Hong Kong offices and overseas branches.*
2. *Classified loans are those loans graded as "substandard", "doubtful" or "loss".*
3. *Net of specific provisions.*
4. *Loans on which interest has been placed in suspense or on which interest accrual has ceased.*

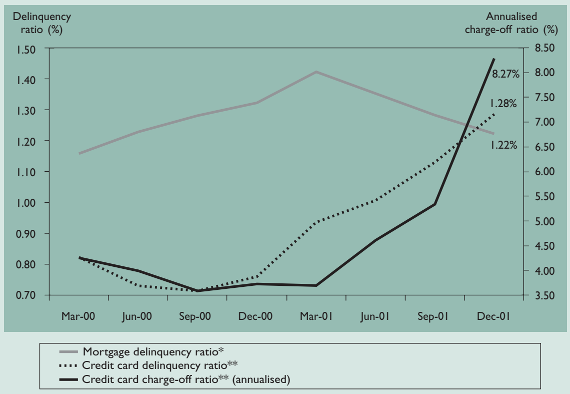
Because of rounding, the figures set out in this table may not add up.

December from 1.28% at end-September (Chart 3). In part, this reflected the efforts by the banks to restructure problem loans, as shown by the rise in the ratio of rescheduled loans from 0.23% to 0.26%.

There are, however, growing concerns about the quality of credit card receivables, which saw a sharp deterioration in the fourth quarter, with the annualised quarterly charge-off ratio increasing to 8.27% and the delinquency ratio to 1.28%, compared to 5.33%[2] and 1.13% respectively in the third quarter (Chart 3). The deterioration appears to have been due primarily to the sharp increase in the number of personal bankruptcies, but was also influenced by a change in policy by a number of

Chart 3

Asset Quality of Credit Card and Mortgage Lending (Surveyed Institutions)



* *There is a break in series at December 2000 owing to increase in the number of surveyed institutions.*

** *There is a break in series at December 2001 owing to increase in the number of surveyed institutions.*

2 Revised from 4.75% following amendments by a reporting institution.

banks which are now charging off accounts earlier (when a bankruptcy petition is presented rather than when a bankruptcy order is issued).

Lending

In the fourth quarter the banking sector's total loans to customers dropped by 2.7% following a decline of 3.0% in the preceding quarter. Loans to customers both inside and outside Hong Kong decreased. Loans to customers outside Hong Kong dropped by 10.2%, driven mainly by the continued contraction in Japanese banks' Euroyen lending activities, while loans to customers inside Hong Kong[3] contracted by 1.4%, reflecting weak domestic loan demand (Chart 4).

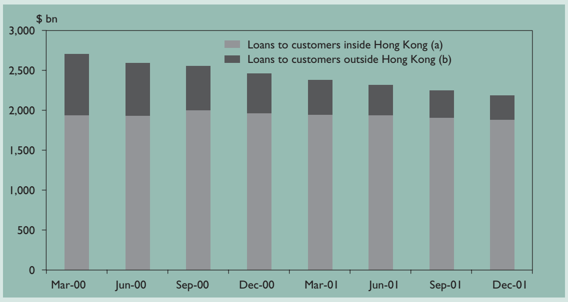
The breakdown of lending by major economic sectors (Chart 5) indicates that property lending rose by 0.5% in the fourth quarter, against a decline of 0.7% in the preceding quarter. The rise was attributable to increases in loans for property development, which grew by 5.2% after falling by 9.4% in the preceding quarter, and residential mortgage loans, which grew by 0.4% following an increase of 0.5% in the preceding quarter. However, loans for property investment declined by 1.4%, against an increase of 1.7% in the preceding quarter.

After rising by 4.1% in the third quarter, loans to the electricity, gas and telecommunications sector fell sharply by 16.3% in the fourth quarter. Within this, aggregate lending to the telecommunications sector[4], which represented 1.8% of the banking sector's total domestic lending at end-December, fell sharply to HK$33.7 billion from HK$48.6 billion[5] at end-September, due largely to repayments made.

At end-September the banking sector's total outstanding exposure to non-bank Chinese entities was HK$168.2 billion (2.6% of the sector's total assets), down by 5.2% at end-June. The reduction was mainly due to loan repayments.

Chart 4

Loans to customers inside and outside Hong Kong (All AIs)



Notes:

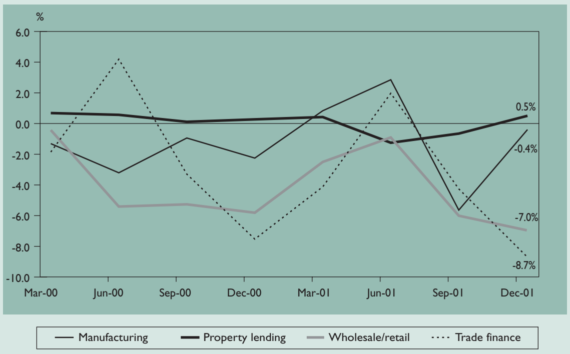
(a) Defined as loans for use in Hong Kong plus trade financing loans.

(b) Includes "others" (i.e. unallocated).

Chart 5

Loans for Use in Hong Kong by Selected Sectors (All AIs)

Quarterly Percentage Change



N.B. Property lending denotes lending for property development & investment and residential mortgage loans (excluding lending under the Home Ownership Scheme, the Private Sector Participation Scheme & the Tenants Purchase Scheme).

3 Defined as loans for use in Hong Kong plus trade financing loans.

4 On-balance sheet lending booked in Hong Kong offices only.

5 Revised from HK$46.2 million following amendments.

Customer Deposits

In the fourth quarter the banking sector's customer deposits declined by 2.3% after remaining flat in the preceding quarter (Chart 6). This is not surprising given the low interest rate environment and the lack of domestic credit expansion. The decline was mainly in foreign currency deposits. Reflecting this, the proportion of Hong Kong dollar deposits to total deposits increased to 55.1% at end-December from 53.8% at end-September.

Continuing the trend of the previous two quarters, the shift from Hong Kong dollar time deposits to savings and demand deposits continued in the fourth quarter as consumers opted for greater liquidity given the low interest rates available on deposits. Both savings and demand deposits recorded strong growth, of 8.7% and 14.0% respectively, while time deposits (including swaps) declined by 5.4%. Table 3 shows the quarterly changes in Hong Kong dollar deposits by type.

Negotiable Instruments

Funding through negotiable certificates of deposit (NCDs) issued fell by 4.1% in the fourth quarter, compared with a decrease of 0.2% in the preceding quarter. Fixed rate instruments continued to dominate the primary NCD market, accounting for 61.0% of new issues. The proportion of the outstanding amount of NCDs held by authorized institutions declined to 50.1% at end-December from 54.9% at end-September.

Chart 6

Customer Deposits (All AIs)
Quarterly Percentage Change

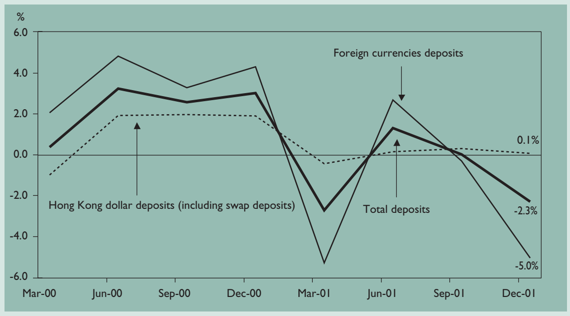


Table 3

Hong Kong Dollar Deposit Mix (All AIs)

Amount (HK$ bn)

	Deposits		
	Demand	**Savings**	**Time***
Dec/00	112.2	492.6	1,243.1
% growth	7.5	12.2	(2.1)
Mar/01	105.4	499.2	1,235.5
% growth	(6.1)	1.4	(0.6)
Jun/01	106.3	540.8	1,196.2
% growth	0.9	8.3	(3.2)
Sep/01	112.6	564.8	1,171.8
% growth	5.9	4.4	(2.0)
Dec/01	128.4	613.9	1,108.6
% growth	14.0	8.7	(5.4)

Notes: % *growth denotes the quarter-on-quarter growth of the deposits*

* *includes swap deposits*

Table 4
NCDs and NDIs (All AIs)

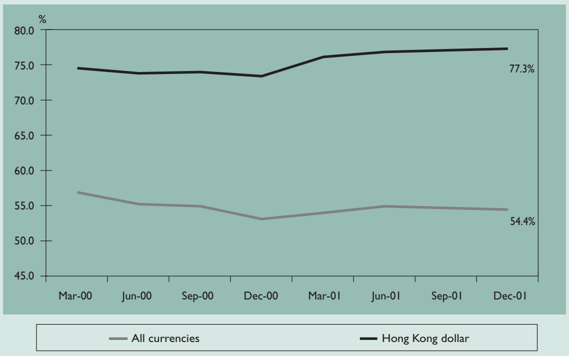
Amount (HK$ bn)

	All Authorized Institutions			
	Total NCDs outstanding	NDIs held HK$	FC	Total
Dec/00	178	329	427	756
% growth	(4.3)	5.4	4.9	5.1
Mar/01	173	373	451	824
% growth	(2.7)	13.5	5.6	9.0
Jun/01	180	369	492	861
% growth	4.2	(1.1)	9.0	4.4
Sep/01	180	392	522	915
% growth	(0.2)	6.4	6.2	6.3
Dec/01	172	354	553	908
% growth	(4.1)	(9.7)	5.9	(0.8)

Note: *% growth denotes the quarter-on-quarter growth of NCDs and NDIs.*

The banking sector's holdings of negotiable debt instruments (NDIs) fell marginally by 0.8%, against an increase of 6.3% in the third quarter (Table 4). Nonetheless, over the year as a whole, NDIs held rose sharply by 20%, following a near 30% increase in 2000. This reflects the switching of surplus funds into debt securities by the banks in view of limited lending and investment opportunities.

Chart 7
Loan-to-Deposit Ratio



Loan-to-Deposit Ratio

The retail banks' overall and Hong Kong dollar loan-to-deposit ratios remained more or less unchanged at around 55% and 77% respectively at end-December (Chart 7). This indicates continued plentiful liquidity and reflects the subdued lending situation.

A table of key performance indicators of the banking sector is at Annex.

- Prepared by the Banking Policy Department

Key Performance Indicators of the Banking Sector[1] (%)

	Dec-00	Sep-01	Dec-01
Interest rates[2]			
1-month HIBOR	5.80	3.30	1.93
3-month HIBOR	5.95	3.28	1.92
BLR and 1-month HIBOR spread	3.70	3.29	3.39
BLR and 3-month HIBOR spread	3.55	3.31	3.41
Balance sheet developments[3]		**All AIs**	
Total deposits	3.0	0.0	-2.3
Hong Kong Dollar	1.9	0.3	0.1
Foreign currency	4.3	-0.3	-5.0
Total loans	-3.6	-3.0	-2.7
Loans to customers inside Hong Kong[4]	-1.7	-1.7	-1.4
Loans to customers outside Hong Kong[5]	-10.4	-9.6	-10.2
Negotiable instruments			
Negotiable debt certificates issued	-4.3	-0.2	-4.1
Negotiable debt instruments held	5.1	6.3	-0.8
Asset quality[6]		**Retail Banks**	
As % of total loans			
Pass loans	86.09	88.05	88.12
Special mention loans	6.65	5.60	5.51
Classified loans (gross)[7]	7.26	6.36	6.37
Classified loans (net)[8]	4.93	4.37	4.53
Overdue > 3 months and rescheduled loans	6.04	4.96	4.57
Non-performing loans[9]	5.87	5.11	4.74
Asset quality		**Surveyed Institutions**	
Delinquency ratio of residential mortgage loans	1.32	1.28	1.22
Credit card receivables			
Delinquency ratio	0.76	1.13	1.28
Charge-off ratio[10]	3.71	5.33	8.27
Profitability		**Retail Banks**	
Net interest margin[11]	2.14	2.01	2.03
Cost income ratio	38.1	40.8	42.3
Bad debt charge as % of average total assets[11]	0.44	0.30	0.33
Capital adequacy ratio (consolidated)		**All Locally Incorporated AIs**	
	17.8	18.3	16.8*

1. *Figures related to Hong Kong office(s) only except where otherwise stated.*
2. *Quarterly average.*
3. *Quarterly change.*
4. *Loans for use in Hong Kong plus trade financing loans.*
5. *Includes "others" (i.e. unallocated)*
6. *Figures relate to retail banks' Hong Kong office(s) and overseas branches.*
7. *Classified loans are those loans graded as "substandard", "doubtful" or "loss".*
8. *Net of specific provisions.*
9. *Loans on which interest has been placed in suspense or on which interest accrual has ceased.*
10. *Quarterly annualised.*
11. *Year-to-date annualised.*

* *Preliminary figure*